

CRTs – Understanding the Process of Charitable Giving

This article appears courtesy of Bryce A. Schintzius. Mr. Schintzius is a representative of the New England Life Insurance Company. He focuses on meeting the individual insurance and financial services needs of gay and lesbian clients in the greater Boston area as well as in New York. You can reach Mr. Schintzius in his office at (781) 788-4644.

New England Life Insurance Company, 501 Boylston Street, Boston, MA 02116

Are you asset rich but income poor? Do you have an appreciated asset that will incur a substantial capital gains tax? Will your estate be exposed to estate taxes? Are you charitably inclined? If you answered “yes” to any of the preceding questions, you may be a candidate for an underutilized, but highly effective, tool called the charitable remainder trust (CRT). Here’s how it works. The process starts with a contribution of assets into an irrevocable trust. The trustee agrees to pay you an income each year for either your life or a term of years. If you select a term of years, as opposed to life payments, the maximum term is 20 years. The minimum payout you must receive is 5 percent, while the maximum is 50 percent. When the trust ends, the remainder of the assets in the trust pass to the charity. It’s as simple as that!

Not so fast...

The fact, is nothing in estate planning is that simple. However, with a basic understanding, you’ll soon see how a CRT might benefit your particular situation. Let’s take a closer look at some of the advantages CRTs provide. Assume that Mr. and Mrs. Smith decided to fund a Charitable Remainder Annuity Trust (CRAT) with \$250,000 of stock they purchased 20 years ago for \$25,000. Because the CRT is tax-exempt, the trustee can sell the Smith’s stock tax-free and reinvest the full \$250,000 in income-producing assets. If the Smiths decided to receive monthly payments for 15 years and set the CRT’s payout rate at 7% (assuming the trust satisfies the required tests), the Smiths would receive an annual income of \$17,500. They would also be able to take a charitable deduction on their personal income tax return (based on the amount of time the charity must wait to receive payment, the percentage rate payable to income beneficiaries, the current rate of return of the investments and the applicable federal interest rate). The charitable income tax deduction that may be claimed for the year of the gift may be limited by the type of property donated, or the kind of organization receiving the gift. If the Smiths’ deduction is limited on their current year’s tax return, IRS rules allow them to carry forward any excess for five years.

In addition to providing the Smiths with a potentially sizeable income tax deduction and enhanced income, the Smiths will realize three additional

benefits. First, since the \$250,000 is no longer in their estate, they have effectively reduced their potential estate tax burden. Second, since there is no tax on the transfer, they have avoided the potential capital gains tax they would have faced had the stock been sold first. Finally, they have provided a significant gift to the charity of their choice.

Even with today's lowering income tax rates, charitable income tax deductions are worth correspondingly more to taxpayers who find themselves in the higher tax brackets. Moreover, since the appreciation on property donated to charity is no longer a preference item for the AMT (alternative minimum tax), donating such property may now be much more advantageous.

(Under prior law, the AMT could, in many cases, have significantly trimmed the income tax deduction for donations of appreciated property.)

One Step Beyond

This intriguing mechanism can be taken one step further. Let's take one last look at Mr. and Mrs. Smith. When the Smiths first took the CRT into consideration, they may have felt some apprehension about transferring property out of their estate for the ultimate benefit of a charity rather than for their children. Sure, being a philanthropist would be nice, they thought. And, the potentially large charitable deduction and future income stream held great appeal. However, what could the Smiths have done to ensure their children would receive something similar (or, perhaps, even greater) in value to the transferred property?

By using the after-tax income and savings from their charitable deduction (and possibly a portion of their monthly income stream), the Smiths could make gifts to an irrevocable life insurance trust (ILIT) which, in turn, would purchase a life insurance policy on the lives of Mr. and Mrs. Smith. Upon their death, the proceeds of the life insurance policy would be passed to the trust beneficiaries (their children) estate and income tax-free.

Philanthropy – It's Up to You

While most people may be resigned to the inevitability of taxation, many may be unaware that they have a choice with respect to estate taxes. Since a certain amount of your money may go to society one way or another, the choice is in what form your "contribution" to society will be. When viewed from the perspective of channeling your funds through the government or directly to the charity of your choice, charitable giving takes on new meaning. The CRT may then become a valuable tool to facilitate this choice.

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